

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 SANTIAGO 12171

E.O. 11652: GDS
TAGS: PFOR ECON CI
SUBJECT: CHILEAN ECONOMIC POLICY; LONG-TERM ECONOMIC PITFALLS

REF: SANTIAGO 12078

1. SUMMARY. REFTEL SET FORTH THE EMBASSY'S CONCLUSION THAT, EVEN THOUGH CONSIDERABLE DISSATISFACTION WITH CHILE'S CURRENT ECONOMIC SITUATION CONTINUES, NO FUNDAMENTAL CHANGES IN GOC ECONOMIC POLICIES ARE IN SIGHT. OVER THE LONGER TERM SATISFACTORY ECONOMIC AND SOCIAL DEVELOPMENT (REDUCED INFLATION AND UNEMPLOYMENT COUPLED WITH GREATER SOCIAL EXPENDITURE AND ECONOMIC GROWTH) WILL DEPEND ON HOW SUCCESSFUL FREE MARKET POLICIES ARE IN (1) ATTRACTING A LARGE VOLUME OF INVESTMENT, (2) REVIVING A LONG STAGNANT AGRICULTURAL SECTOR, (3) ESTABLISHING A SMOOTHLY FUNCTIONING FINANCIAL SYSTEM, AND (4) RESTRUCTURING CHILE'S HIGHLY INEFFICIENT INDUSTRIAL SECTOR. WEAKNESS IN THESE AREAS COULD CREATE A GUNS/BUTTER DILEMMA SHOULD THE JUNTA DECIDE TO SPEND LARGER AMOUNTS OF FOREIGN EXCHANGE AND ADDITIONAL DOMESTIC RESOURCES ON DEFENSE. FAILURE IN THESE AREAS WOULD UNDERMINE THE VITALITY OF THE ECONOMIC TEAM'S FREE MARKET POLICIES AND THREATEN FAR-
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REACHING CHANGES IN ECONOMIC POLICY. WE WILL FOLLOW THESE ISSUES CLOSELY IN THE MONTHS AHEAD. END SUMMARY.

2. FOREIGN INVESTMENT - THE ECONOMIC TEAM ARGUES THAT A LOW GROWTH RATE HAS BEEN A PRINCIPAL HISTORIC CAUSE OF SOCIAL TENSIONS IN CHILE. IN THEIR VIEW, UNJUSTIFIED EXPECTATIONS OF

EVER GREATER PROSPERITY WERE CREATED AS THESE FAILED TO BE REALIZED, DISPUTES OVER THE DISTRIBUTION OF INCOME BECAME MORE ACUTE. THE REMEDY IS MORE INVESTMENT WITH HIGHER RATES OF RETURN, WHICH GREATER RELIANCE ON THE MARKET IS SUPPOSED TO ASSURE. IN A FREE MARKET SYSTEM, HOWEVER, THERE IS NO ASSURANCE THAT DOMESTIC SAVINGS WILL BE SUFFICIENT TO ATTAIN GROWTH OBJECTIVES. INDEED, NEW FINANCE MINISTER SERGIO DE CASTRO HAS PUBLICLY ACKNOWLEDGED THAT, GIVEN A CHOICE BETWEEN SAVINGS AND CONSUMPTION, NATURAL CHILEAN PROPENSITIES WOULD RESULT IN TOO FEW SAVINGS. HENCE THE PRICE PAID FOR FOREIGN INVESTMENT, GOING TO SUCH LENGTHS AS THE RENUNCIATION OF OFFICIAL U.S. ECONOMIC AID. (THE SYLLOGISM IS INVOKED THAT, AMONG OTHER DIFFICULTIES, SUCH AID STIMULATES CONGRESSIONAL DEBATE, WHICH GENERATES NEWSPAPER STORIES HOSTILE TO CHILE, WHICH TEND TO DISCOURAGE INVESTORS.)

3. RENOUNCING AID DOES NOT, BY ITSELF, BUOY INVESTOR CONFIDENCE. NOR, APPARENTLY, DOES LIBERAL LEGISLATION REGARDING REMITTANCES, IMPORT PRIVILEGES AND THE LIKE. FOREIGN INVESTMENT IS ONLY TRICKLING IN. BUREAUCRATIC INERTIA AS WELL AS LEGISLATION BUILDING IN OPPORTUNITIES FOR BUREAUCRATIC OBSTRUCTION ARE PARTLY AT FAULT. MARKET UNCERTAINTIES, ABROAD AS WELL AS AT HOME, ARE PROBABLY FUNDAMENTAL DETERRENTS TO INFLOWS OF LONG-TERM CAPITAL HERE AS ELSEWHERE. HIGH INTERNATIONAL INTEREST RATES MOREOVER, DISCOURAGE INVESTOR INTEREST IN THE CAPITAL-INTENSIVE COPPER SECTOR; THE SMALLNESS OF THE DOMESTIC MARKET, CHILE'S UNCERTAIN PROSPECTS, AND PROBLEMS OF MARKET ACCESS UNDOUBTEDLY DIMINISH INVESTOR INTEREST IN THE MANUFACTURING SECTOR.

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4. BUREAUCRATIC FOOT DRAGGING, AND THE NEED TO ELIMINATE LEGAL OBSTRUCTIONS, SEEM AT LAST TO HAVE GOTTEN ATTENTION AT HIGH LEVELS. BUT A PREFERENCE FOR NATIONAL AS OPPOSED TO FOREIGN INVESTMENT, TO THE POINT WHERE NO INVESTMENT AT ALL SEEMS BETTER THAN INVESTMENT BY FOREIGNERS, SEEMS STILL TO PREVAIL AMONG SOME CIVILIANS AND MILITARY. EVEN ASSUMING THAT THESE DOMESTIC OBSTACLES ARE OVERCOME, AND EVEN IF CHILE'S INTERNATIONAL IMAGE IMPROVES SUBSTANTIALLY, WE STILL WONDER WHETHER CHILEAN POLICY MAKERS HAVE IT WITHIN THEIR POWER TO INDUCE, ON PURELY ECONOMIC GROUNDS, A CAPITAL INFLOW SUFFICIENT TO SATISFY CHILE'S INVESTMENT REQUIREMENTS FOR SUBSTANTIAL GROWTH.

5. AGRICULTURE. THE AGRICULTURAL SECTOR WAS SUPPOSED TO RESPOND WITH A SURGE IN OUTPUT ONCE THE ARTIFICIAL BARRIERS IMPOSED BY THE ALLENDE AND EARLIER REGIMES WERE REMOVED. THE OUTPUT OF A FEW CROPS, NOTABLY SUGAR BEETS, HAS RISEN

DRAMATICALLY. NEVERTHELESS, THREE YEARS AFTER THE ELIMINATION OF THE ALLENDE GOVERNMENT, OVERALL AGRICULTURAL OUTPUT IS APPROXIMATELY THE SAME AS IN 1972. POLICY MAKERS ARE FINDING OUT THAT THE REMOVAL OF MARKET IMPERFECTIONS, SUCH AS SUBSIDIZED IMPORTS AND THREATS TO THE SECURITY OF PROPERTY, DO NOT NECESSARILY RESULT IN AN IMMEDIATE JUMP IN PRODUCTIVITY. THE PROCESS OF RATIONALIZATION -- FOR EXAMPLE, THE TERMINATION OF CHEAP CREDIT AND INPUT SUBSIDIES RAISED COSTS OF FARMERS -- ALSO HAS A DAMPENING AS WELL AS AN ENCOURAGING EFFECT ON AGRICULTURAL PRODUCTION. GREATER EXPOSURE TO INTERNATIONAL AND DOMESTIC MARKET COMPETITION HAS IN SOME INSTANCES CREATED PRICE AND COST UNCERTAINTIES, WITH A CONSEQUENT IMPEDIMENT TO OPTIMAL OUTPUT DECISIONS.

6. DESPITE GOC EFFORTS TO HASTEN THE COMPLETION OF THE LAND REFORM PROGRAM, THE CHILEAN AGRICULTURAL SCENE CONTINUES TO BE BEDEVILLED BY LAND TENURE PROBLEMS. IT WILL PROBABLY TAKE SEVERAL YEARS BEFORE SATISFACTORY ECONOMIC AND SOCIAL

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SOLUTIONS TO THE PROBLEMS OF UNECONOMIC LAND UNITS, RURAL UNEMPLOYMENT, INEFFICIENT MANAGEMENT, AND ENCUMBRANCES TO LAND DISPOSAL CAN BE APPLIED. IN THE MEANTIME OUTPUT OF THE SECTOR WILL SUFFER.

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7. CAPITAL MARKETS - THE RESTRUCTURING OF THE FINANCIAL SYSTEM HAS MUCH THE SAME FLAVOR AS ECONOMIC REFORMS IN THE AGRICULTURAL AND PUBLIC SECTORS. THESE REFORMS CONTRIBUTE TO LONG-TERM DEVELOPMENT, BUT AT THE EXPENSE OF SOME SHORT-TERM OBJECTIVES. REPRIVATIZATION OF THE COMMERCIAL BANKING SYSTEM, LIFTING THE RESTRAINTS ON LENDING ACTIVITIES, AND LIBERALIZING CAPITAL FLOWS SHOULD EVENTUALLY RESULT IN LARGER VOLUMES AND HIGHER RATES OF SAVINGS AND INVESTMENTS. THE SHORT-TERM EFFECT, HOWEVER, HAS BEEN PRETTY MUCH TO COLLAPSE SUCH INVESTMENT ACTIVITY AS THERE WAS. IN RECENT MONTHS, THE CENTRAL BANK HAS HAD GREATER SUCCESS IN REDUCING MONETARY EXPANSION. MONETARY RESTRICTIONS FOR INFLATION CONTROL PURPOSES, HOWEVER, COMBINED WITH THE FREEING OF INTEREST RATES HAVE MADE LONG-TERM INVESTMENTS FINANCED FROM INTERNAL SAVINGS PROHIBITIVELY EXPENSIVE. CONSTRUCTION ACTIVITY CAME TO A VIRTUAL HALT DURING 1975 AND 1976. IN TIME, THE FINANCIAL SYSTEM SHOULD MAKE THE APPROPRIATE ADJUSTMENTS AND LONGER-TERM INVESTMENT PROJECTS SHOULD AGAIN BECOME FEASIBLE.

8. RESTRUCTURING A RICKETY INDUSTRIAL SYSTEM - EVEN MORE CONTROVERSIAL THAN FOREIGN INVESTMENT HAS BEEN THE POLICY OF CONFIDENTIAL

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REDUCING TARIFF RATES TO ONLY MODERATELY PROTECTIVE LEVELS. OVER THE PAST THIRTY YEARS, CHILE'S INDUSTRY HAS BEEN DEVELOPED BEHIND SOME OF THE NON-COMMUNIST WORLD'S HIGHEST BARRIERS. MANY OF THESE INDUSTRIES PROBABLY CANNOT CONTINUE TO SURVIVE WITHOUT SUBSTANTIAL PROTECTION. FALLING TARIFFS, COMBINED WITH A REAL APPRECIATION OF THE PESO IN RECENT MONTHS, HAVE SHAKEN THE COMPETITIVE POSITION OF LOCAL PRODUCERS OF INTER ALIA, TEXTILES, SHOES, AND CONSUMER DURABLES. OPPOSITION IN THE BUSINESS SECTOR TO THIS PARTICULAR ASPECT OF GOC ECONOMIC POLICY HAS RISEN ACCORDINGLY.

9. ALTHOUGH THE GOC HAS BEGUN TO INSTITUTE ANTI-DUMPING PROCEDURES PRIMARILY TO HEAD OFF DEMANDS FOR SPECIAL PROTECTION OF CERTAIN INDUSTRIES, THERE ARE AS YET NO INDICATIONS THAT THE GOC'S COMMITMENT TO LIBERAL TRADE POLICIES IS WEAKENING UNDER A CHORUS OF PROTECTIONIST SENTIMENTS. IMPORTS ARE BEGINNING TO MAKE A DENT IN SOME CONSUMER MARKETS (E.G. TEXTILES) AND UNDOUBTEDLY ACCOUNT FOR SOME OF THE SUCCESS OF LATE IN REDUCING INFLATION RATES. ADJUSTMENTS IN THE INDUSTRIAL SECTOR, HOWEVER, COME AT SOME EXPENSE TO SHORT-TERM EMPLOYMENT AND PRODUCTION. IMPORTS DEPRESS DEMAND FOR LOCAL PRODUCTION AND WORKERS ARE FIRED. IN THE ABSENCE OF NEW INVESTMENT ACTIVITY, CHANCES OF FINDING COMPARABLE ALTERNATIVE EMPLOYMENT ARE DIM. THESE POLICIES MAY

EVENTUALLY RESULT IN A MORE EFFICIENT INDUSTRIAL STRUCTURE. THAT, HOWEVER, IS COLD COMFORT TO BUSINESSMEN WHO INVESTED BEHIND HIGH TRADE BARRIERS, AS WELL AS TO WORKERS WITHOUT JOBS.

10. INDUSTRIAL EFFICIENCY DEPENDS ON MARKET ACCESS - ONE OF THE ASSUMPTIONS OF THE GOC'S "MONETARIST" ECONOMISTS IS THAT A SOUND ECONOMY DEPENDS ALMOST EXCLUSIVELY ON GOOD ECONOMIC POLICY. THEY ASSUME THAT WHILE THE TERMS OF TRADE, FOREIGN OFFICIAL ASSISTANCE, AND SPECIAL MARKETING ARRANGEMENTS (SUCH AS THE ANDEAN PACT) MAY AFFECT A COUNTRY'S SHORT-
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TERM PROSPECTS, IN THE LONG-TERM A RELATIVELY UNENCUMBERED MARKET WILL ASSURE PROSPERITY ON A SOUND BASIS BY PROMOTING EFFICIENT PATTERNS OF TRADE AND PRODUCTION. BY CONTRAST WITH STRUCTURALIST-ORIENTED ECONOMISTS, WHO PERCEIVE CHILE'S WITHDRAWAL FROM THE ANDEAN PACT AS A LOSS OF MARKET ACCESS WITHOUT SUBSTITUTES HAVING BEEN FOUND, THE ECONOMIC TEAM IS DISPOSED TO BELIEVE THAT MORE THAN ADEQUATE COMPENSATION WILL COME FROM CLOSER ECONOMIC ASSOCIATION WITH THE RICHER ARGENTINE, BRAZILIAN, AND OTHER NEARBY MARKETS. WHETHER THIS TRANSITION WILL GO AS SMOOTHLY AS THEY SEEM TO ASSUME REMAINS TO BE SEEN. CERTAINLY, NO DRAMATIC NEW MARKET OPPORTUNITIES, EITHER FOR "SOUTHERN CONE" INVESTMENT IN CHILE, OR FOR INCREASED CHILEAN EXPORTS TO THOSE COUNTRIES, HAVE THUS FAR COME TO LIGHT.

11. NOR IS THERE ANY ASSURANCE THAT WORLD ECONOMIC CONDITIONS WILL FAVOR EXPORT-LED GROWTH TO THE SAME DEGREE AS THEY DID BRAZIL'S, KOREA'S, AND TAIWAN'S ECONOMIC "TAKE-OFF" A DECADE AGO. PERIODIC OIL CRISES AND A LACK-OF-LUSTER RECOVERY IN INDUSTRIALIZED COUNTRIES TEND TO DAMPEN DEMAND FOR COPPER, THEREBY REDUCING COPPER REVENUES AND PROBABLY COPPER INVESTMENTS AS WELL. CHILE MIGHT ALSO FIND IT MUCH MORE DIFFICULT TO PLACE INDUSTRIAL AND OTHER MINERAL EXPORTS IN FOREIGN MARKETS IN WHICH DEMAND HAS BEEN DEPRESSED BY A SLOW AND ERRATIC PACE OF ECONOMIC EXPANSION.

12. GUNS AND BUTTER - FINALLY, RISING DEFENSE EXPENDITURES COULD CLOUD THE ECONOMIC TEAM'S VISIONS OF A MARKET-ORIENTED ECONOMY IN WHICH THE ROLE OF GOVERNMENT IS SUBSIDIARY. A BREAKDOWN IN THE NEGOTIATIONS FOR A BOLIVIAN CORRIDOR TOGETHER WITH CONTINUING PERUVIAN ARMS PURCHASES, WOULD PROBABLY LEAD TO STILL HIGHER DEFENSE OUTLAYS, WHICH ARE ALREADY ABOUT SIX PERCENT OF GDP. IN THE ABSENCE OF HIGHER COPPER REVENUES, THE FOREIGN EXCHANGE RESOURCES NEEDED TO BEEF UP CHILE'S MILITARY MATERIAL WOULD HAVE TO BE EXACTED FROM THE PRIVATE SECTOR. WHILE CHILE
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HAS HAD SUBSTANTIAL SUCCESS IN INCREASING ITS NON-COPPER FOREIGN EXCHANGE REVENUES THESE PAST TWO YEARS, THE PROSPECTS FOR SUSTAINING THIS PERFORMANCE IN THE YEARS IMMEDIATELY AHEAD ARE NOT VERY BRIGHT. HIGHER DOLLAR DEFENSE EXPENDITURES, GIVEN THESE ASSUMPTIONS, WOULD IN LARGE MEASURE BE AT THE EXPENSE OF DOMESTIC INVESTMENT.

13. INTERNALLY, A LARGER DEFENSE BUDGET WOULD REQUIRE EITHER A HEAVIER TAX BURDEN OR THE SACRIFICE OF SOCIAL PROGRAMS. A FAVORITE THEME WITH SUPPORTERS OF THE ECONOMIC TEAM'S POLICIES IS THAT THE PRESENT TAX BURDEN IS ALREADY SO ONEROUS AS TO THREATEN THE DEVELOPMENT OF A DYNAMIC PRIVATE SECTOR. NONE WOULD ADVOCATE HIGHER TAXES AND MANY IF NOT MOST WOULD ADVOCATE A SUBSTANTIAL REDUCTION. IF PRIVATE SECTOR DEVELOPMENT IS THEN TO BE FOSTERED, THIS WULD HAVE TO BE DONE AT THE EXPENSE OF THE SOCIAL SECTORS -- HOUSING, HEALTH, EDUCATION, SANITATION, ETC. THIS WOULD, HOWEVER, JETTISON A KEY JUSTIFICATION FOR LIBERAL ECONOMIC POLICIES. A PROSPEROUS ECONOMY SHOULD GENERATE THE REVENUES WITH WHICH TO FUND GOC SOCIAL PROGRAMS TO PULL UP THOSE AS YET UNABLE TO PARTICIPATE IN A FREE MARKET ECONOMY. EITHER WAY, THE ATTRACTIVENESS OF LIBERAL ECONOMIC POLICIES WOULD BE SULLIED AND GREATER HEAD WOULD BE PAID TO THOSE ADVOCATING ALTERNATIVE DEVELOPMENT STRATEGIES.

14. CONCLUSIONS. ECONOMIC POLICY IS FIRMLY FIXED FOR THE SHORT-RUN. ECONOMIC RECOVERY WILL BE SLOW; UNEMPLOYMENT HIGH, AND INFLATION, AT UNCOMFORTABLE ALBEIT LOWER LEVELS; AND PROGRESS TOWARD THE REALIZATION OF THE REGIME'S SOCIAL OBJECTIVES, SPOTTY, FOR AT LEAST THE NEXT COUPLE OF YEARS. MUCH OF THE BUSINESS SECTOR WILL CONTINUE TO ATTACK FREE TRADE POLICIES, AGRICULTURE WILL REMAIN A THORNY SECTOR FOR SOCIAL AND ECONOMIC REASONS, AND LABOR WILL BE FURTHER DISGRUNTLED AS ECONOMIC ADJUSTMENT TAKES ITS TOLL.

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15. CURRENT LIBERAL MARKET POLICIES CAN SURVIVE PROVIDED (1) CHILE ACHIEVES THE MODEST GROWTH AND INVESTMENT RATES NECESSARY TO EXPAND EMPLOYMENT AND INCOME, (2) A STABLE, REASONABLY INFLATION-FREE (BY CHILEAN HISTORIC STANDARDS) ECONOMY IS ESTABLISHED, AND (3) A STEADILY LARGER VOLUME OF RESOURCES CAN BE MADE AVAILABLE FOR SOCIAL OBJECTIVES. IN THE LONG RUN, FOREIGN PRIVATE INVESTMENT, LOANS FROM THE IFI'S,

AND FAVORABLE MARKET ACCESS FOR CHILE'S "NON-TRADITIONAL"
EXPORTS WILL BE NEEDED IN SOME DEGREE TO ACHIEVE THE REGIME'S
ECONOMIC OBJECTIVES. RESTRICTING DEFENSE EXPENDITURES
WILL BE IMPORTANT FOR THE ACHIEVEMENT OF SOCIAL OBJECTIVES.

16. ON THE OTHER HAND, IF BECAUSE OF EXTERNAL OR INTERNAL
STRESS, THE ECONOMIC TEAM FAILS TO MOVE THE COUNTRY TOWARD
ITS ECONOMIC AND SOCIAL OBJECTIVES, CURRENT POLICIES WILL
CERTAINLY BE SACRIFIED FOR A MORE DIRIGISTE STYLE. WE
THINK THE MOMENT OF DECISION IN THIS REGARD IS STILL
DISTANCE AWAY. AND WE ARE BY NO MEANS CERTAIN WHICH WAY THE
TIDE WILL ULTIMATELY TURN.
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